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To target inflation, NBU and Government must coordinate policies

On 2 July 2007, the International Centre for Policy Studies held a roundtable called "What kind of monetary regulation does Ukraine need?" Participants included representatives of the National Bank of Ukraine, commercial banks, ICPS, and other think-tanks. They discussed the advantages and drawbacks of the current system for regulating the exchange rate, the options for changing in Ukraine's monetary policy and related problems

What's wrong with the current approach?

ICPS economist Oleksandr Zholud presented a report on Ukraine's monetary policy and possible options for regulating the exchange rate. Generally accepted monetary regulation includes three approaches to exchange rate policy: targeting the exchange rate (Ukraine does this), targeting the growth of monetary aggregates and targeting inflation.

While a fixed exchange rate policy has clear advantages, the ICPS economist emphasized the risks related to the current monetary regime, using two scenarios: a negative external shock and a positive external shock. A negative shock might include deteriorating conditions of trade, such as a collapse in steel prices and/or rising prices for imported gas. Due to the low elasticity of imports, this would cause the current account deficit to grow rapidly. In response to significantly shrinking foreign currency reserves, the NBU would have to resort to either major depreciation or further restrictions on the movement of capital.

A positive shock would lead to a sharp improvement in the conditions of trade and a serious inflow of foreign currency. But the country is not ready to sterilize huge amounts of foreign currency. This would force a revision of the exchange rate and/or it would spur inflation.

To avoid these threats, monetary regulation requires greater flexibility. ICPS economists say the best option for achieving this goal is to switch to targeting inflation, that is, to subordinating monetary policy—primarily exchange and interest rate policies—to the purpose of supporting the inflation rate at a targeted level. Targeting inflation would contribute not only to price stability, but also to the avoidance of distortions in the balance of payments and to reducing the risks of losses from price shocks on global markets.

The main problem is Government–NBU coordination

NBU Director for Monetary Policy Natalia Hrebenyk noted that the source of inflation in recent years had been primarily non-monetary, which makes it harder to target inflation. In addition, large amounts of unspent money on the Government's Treasury accounts restrict options for NBU interest rate policy regarding the money mass in the country.

NBU Director for Economic Analysis and Forecasting Oleksandr Petryk said that, in practice, the majority of countries used mixed systems, not limiting themselves to pure targeting of inflation. This is why Ukraine should consider the possibility of instituting a mixed system of monetary regulation. According to Mr. Petryk, a critical pre-condition for targeting inflation is coordination between the Government and the central bank. To institute such a regime, the two will have to:

- complete structural reforms;
- implement pension reform;
- coordinate fiscal and monetary policy;
- liberalize price controls;
- develop financial markets.

By the way…

On 6 July 2007, the International Center for Policy Studies held a roundtable called "Right Turn: France's experience and elections in Ukraine." At this roundtable, ICPS presented a brief on the successful experience of France's rightists in dissipating leftist stereotypes and promoting liberal values and reforms during the 2007 presidential election. Participants included high-profile politicians, Government officials, businesspeople, specialists, and representatives of foreign countries, such as, the Head of the French Delegation to the Parliamentary Assembly of the OSCE and UMP faction Deputy to the French Parliament Michel Voisin; member of the French Delegation to the Parliamentary Assembly of the OSCE and PS faction Deputy to the French Parliament Alain Neri, VR Deputy Oksana Bilozir, VR Deputy Yuriy Miroshnychenko, Viche leader and Deputy Minister of Justice Inna Bohoslovska, Presidential Adviser Oleh Rybachuk, PORA leader Andriy Yusov, Honorary Chair of the ICPS Supervisory Board and President of the National Academy of Public Administration under the President of Ukraine Vira Nanivska, ICPS Director Volodymyr Nikitin, ICPS expert Natalia Shapovalova, 5 Kanal anchor Yegor Sobolyev, Expert political editor Oleh Voloshyn, Haidai.Com Director for Strategic Planning Serhiy Haidai, and First Counsellor at the Embassy of France to Ukraine Hugues Fantou. (The next ***ICPS newsletter*** will present the results of this discussion.)

Andriy Blinov, research editor for Expert, a Ukrainian business journal, noted that, according to the "impossible trinity" coined by Robert Mundell, the Ukrainian monetary system de-facto chose a fixed exchange rate, supporting restrictions on the movement of capital and independent monetary policy (see ***quarterly predictions*** for Q4'04, p. 72). According to Mr. Blinov, two processes should precede targeting inflation: the liberalization of prices, especially in energy trading, and greater monetization of the economy. As two intermediate options, Mr. Blinov looked at the possibility of expanding the exchange rate corridor or pegging the hryvnia to a basket of currencies rather than just the US dollar. Also, there is a need to develop a market of foreign currency futures operations in Ukraine.

Mr. Petryk said that it was quite risky to make the exchange rate more flexible without thorough analysis. He went on that, as there are no serious opportunities to regulate the monetary system using non-foreign-currency instruments such as the interest rate, a fixed exchange rate continues to be a strong anchor for economic stability.

Participants agreed that it was impossible to target inflation at the level of the National Bank alone. The policies of managing Government funds and regulating prices are critical in terms of effective inflation targeting. This is why the mechanisms for cooperation between the Government and the NBU and adherence to these mechanisms provide a guarantee when switching to a new model of monetary policy. Unfortunately, lack of interest in the Government in this issue—there was no one from either the Ministry of Economy or the Ministry of Finance at this roundtable—makes the prospect of changing monetary regulation poor. Mr. Petryk noted that in all countries using this system, the initiator was actually the Government and not the central bank. Organizing a switch to targeting inflation takes several years, so Ukraine is losing time through inaction. Should the country face external shocks, this delay could cost the economy dearly. ■

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Synchronizing Ukraine's WTO accession with other countries makes little sense

According to a press release from the Ministry of Economy of June, Ukraine and Kazakhstan intend to coordinate their efforts to accede to the World Trade Organization (WTO). Earlier, there were propositions that Ukraine should synchronize this process with the Russian Federation. But ICPS economist Kateryna Malyuhina says it makes little sense for Ukraine to coordinate its accession to the WTO with other countries who are also seeking membership. For one thing, Ukraine's accession process is almost complete. For another, Ukraine's foreign trade priorities are different from the priorities of other candidate countries.

Synchronizing the WTO accession process does make sense for countries in a customs union. Its purpose in this instance would be to establish the same rules of play for all members of that union, so that no obstacles to regional trade emerge after accession. This kind of coordination requires that the countries accede to the WTO under the same conditions: all the countries open access to specific markets, lower their customs duties to the same level and negotiate the same transition periods.

However, Ukraine is not a member of any customs union. There are differences in trade policy today and they will remain after WTO accession. This means that accession itself will not set up additional barriers to trade. Consequently, Ukraine does not need to synchronize accession with Kazakhstan, Russia, or any other country.

To benefit from synchronization, it is also important that two more conditions be fulfilled. Firstly, both countries should be at the same, preferably early, stages of negotiation. If both countries have nearly completed the negotiation process, neither will be willing to start this process all over again just to eliminate discrepancies among various negotiated points. Moreover, if one of the countries lags significantly behind the other, as is the case with Kazakhstan, it will have to agree on the basis of some one else's accession conditions. The other condition for successful synchronization in the WTO accession process is for the two candidate countries to espouse identical priorities for economic growth. One and the same sectors of both economies should require priority measures or a more liberalized market. Otherwise, measures that are good for one country could pose threats for the other one's economy.

The ICPS analyst says that these conditions for effective synchronization do not apply to Ukraine. All the parameters for Ukraine's accession have already been determined and enshrined in legislation. Moreover, only a few technical procedures stand between Ukraine and membership. As of today, other candidate countries have not yet completed the main negotiation process. For instance, the Russian Federation is in talks with three WTO members: Vietnam, Georgia and Cambodia. Kazakhstan has signed bilateral protocols with only 16 of 39 countries that are members of its Working Party and is still in negotiations with such major WTO members as Australia, Canada, the EU and the US, whereas Ukraine only needs to finalize negotiations with Kyrgyzstan. Nor has Kazakhstan completed the adaptation of its legislation and system of state standards to WTO norms and rules.

Ukraine's GDP and foreign trade differ significantly in structure from those of Russia and Kazakhstan. Therefore, there are major differences in the countries' trade policies. For instance, import duty on farm equipment in Ukraine will encourage domestic equipment to become more competitive, whereas in Kazakhstan, it would be harmful. Lacking its own manufacturers, all this would do is unreasonably increase the cost of such equipment for Kazakhstan's farmers.

According to Ms. Malyuhina, for Ukraine to synchronize accession with Kazakhstan or any other candidate country can only have negative consequences: postponing Ukraine's accession indefinitely and changing conditions in a direction that will benefit neither Ukraine nor its ostensible partner in accession.

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